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HEALTH CARE LEGISLATION – NONDISCRIMINATION REQUIREMENT EXPANDED TO HEALTH INSURANCE PROVIDED BY EMPLOYER TO “HIGHLY COMPENSATED” EMPLOYEES AND RETIREES *written by Terry C. Hancock, Nyemaster Goode, P.C.*

The Health Care Act signed into law last March by President Obama provides that insured group health plans that are subject to the Health Care Act will be subject to the same nondiscrimination standards under Internal Revenue Code (“IRC”) Section 105(h) that are currently in place for self-insured health plans (although subject to a different penalty structure).

This new prohibition on discrimination does not apply to group health plans that qualify as “grandfathered” plans under the Health Care Act. Once a plan loses its “grandfathered” status, it will be subject to the prohibition on discrimination for plan years or policy years beginning on and after the loss of “grandfathered” status (but not earlier than years beginning on or after September 23, 2010).

BACKGROUND

Generally, the value of insured and self-insured health benefits provided to employees or retirees is not subject to income tax under the IRC. However, certain nondiscrimination rules under IRC Section 105(h) apply to self-insured benefits, which can result in the loss of this tax favored treatment.

If an employer provides self-insured benefits that discriminate in favor of highly compensated employees (“HCE”), the value of those “additional” benefits are included in the taxable income of the HCE.

The definition of HCE for IRC Section 105(h) purposes includes the 5 highest paid officers, any 10% owners and the highest paid 25% of all employees (typically this is a broader group than under the retirement plan definition of HCE).

A self-insured plan cannot discriminate in favor of HCE’s either as to eligibility to participate or benefits. Discrimination as to benefits exists if benefits to HCE’s are better than those to non-HCE’s (an annual physical exam being excluded). Discrimination as to eligibility exists unless the plan benefits (1) 70% or more of all employees, (2) 80% or more of all employees who are

eligible to benefit under the plan if 70% or more of all employees are eligible, or (3) such employees as qualify under a classification that the IRS finds to be nondiscriminatory.

In applying the mathematical eligibility tests, the following employees may be excluded:

1. Employees who have completed less than 3 years of service.
2. Employees under age 25.
3. Employees covered by a collective bargaining agreement.
4. Employees who are nonresident aliens and receive no U.S. source income.

Under the regulations, retirees are treated as a separate group in determining discrimination. For example, if a retired executive continues to be covered by the self-insured group plan after retirement, but other retirees are not eligible, discrimination occurs.

Unfortunately, the regulations under IRC Section 105(h) were issued in 1981. The prohibition was designed to prohibit small business owners from being provided with generous health benefits not available to other employees. Since then, extended benefits to executives and retired executives have become popular, taking many different forms. As a result, there are unanswered questions about the exact operation of the existing prohibition on discrimination for self-insured plans. In addition, the IRS has refused to issue private letter rulings in this area.

Many employers, in order to avoid the nondiscrimination rules for self-insured plans have provided "additional" health benefits to executives or owners or extended benefits to retired executives through individual insured policies, thus avoiding the adverse tax consequences of IRC Section 105(h). Or, for retired executives, providing a cash payment (with gross-up for taxes) to pay for the COBRA premium for the extended COBRA coverage period under the self-insured plan.

NONDISCRIMINATION UNDER HEALTH CARE ACT

For plan years beginning on or after September 23, 2010, the Health Care Act amended the Public Health Service Act (PHSA) in regard to discriminatory insured group health plans. These amendments impose similar nondiscrimination rules on insured group health plans that apply to self-insured plans. This prohibition will apply to existing group health policies that lose grandfathered status and to new group health policies issued on or after September 23, 2010.

Assuming grandfathered status is lost, for policy years beginning on and after September 23, 2010, if the insured arrangement for an HCE or retired HCE violates the nondiscrimination rules described above for self-insured arrangements, the penalty is not inclusion in income of the value of the additional benefits (as is the case with self-insured discriminatory plans). This was made clear by a recent IRS announcement requesting comments on the nondiscrimination provisions of the Health Care Act (IRS Notice 2010-63).

Rather, under Internal Revenue Code Section 4980D, the employer will be subject to an excise tax of \$100 per day for each participant adversely affected by the discrimination. The IRS has the discretion to waive all or part of the tax to the extent the failure was due to reasonable cause and not willful neglect. **Significantly, the new excise tax does not apply to small employers with between 2 and 50 employees.**

In addition, the DOL is given the authority under ERISA to take enforcement action against a discriminatory plan (even small employer plans), although no penalties are imposed under ERISA.

INDIVIDUAL POLICIES

The new prohibition applies to insured group health plans. Does this mean that if a company provides an individual health insurance policy to an executive or retired executive (obviously subject to underwriting), with the remaining employees covered under a separate insured group health plan, the individual policy is not subject to the new Health Care Act nondiscrimination rules? Apparently, it would not be subject to these new rules because it is an individual policy and not a group policy.

CONCLUSION

It is incumbent on employers with insured group health plans that provide additional benefits (other than annual physicals) to HCE's or retired HCE's to review those policies to determine whether the nondiscrimination rules will be violated (if the plan is not grandfathered) and take appropriate corrective action before the effective date of the new rules.

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